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In the Supreme Court of the United States

OCTOBER TERM, 1965

No. ~~1921~~ 1411.

FORRESTER A. CLARK, ET ALS.,
PETITIONERS,

v.

THE UNITED STATES OF AMERICA,
RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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THE UNITED STATES OF AMERICA,
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The petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the First Circuit entered in the above entitled cause on March 14, 1966.

Opinion Below

The opinion has not yet been officially reported. A copy is appended hereto.

Jurisdiction

The judgment of the Court of Appeals was entered on March 14, 1966. (R. 126) A timely petition for rehearing was filed on March 24, 1966 and denied on April 27, 1966. (R. 136) The jurisdiction of this Court is invoked under 28 U.S.C. Sec. 1254 (1).

Questions Presented

1. Whether the Court of Appeals misapplied the decision of this Court in *Whipple* v. *Commissioner*, 373 U.S. 193 and thereby deprived plaintiff of his right to jury trial under the Seventh Amendment of the Constitution of the United States by converting issues that this Court there said were factual into questions of law?

2. Whether the decision of the Court of Appeals conflicts with the Court's decision in *Whipple* v. *Commissioner*, 373 U.S. 193 by the Court of Appeal's substitution of its judgment as a matter of law for a jury's determination of fact that stock and stock options received by taxpayer represented compensation proximately related to the taxpayer's trade or business of seeking out, promoting, organizing, financing and managing business enterprises?

3. Whether the Court of Appeals misunderstood the decision of this Court in *Whipple* v. *Commissioner*, 373 U.S. 193 by requiring a taxpayer who shows that he is engaged in an independent trade or business of seeking out, promoting, organizing, financing and managing business enterprises to prove also that taxpayer intended to develop the corporations as going businesses for sale to prospective investors in order to deduct worthless bad debts as business bad debts under 26 U.S.C. sec. 166.

4. Whether the Court of Appeals decision misapplied *Whipple* v. *Commissioner*, 373 U.S. 193 and conflicts with

the decision of the Court of Appeals for the Second Circuit in *Weddle* v. *Commissioner*, 325 F.2d 849, by requiring taxpayer to prove that his loss producing activities were not equally consistent with his being an investor, rather than considering the taxpayer's testimony that the bad debts were significantly motivated by his trade or business.

5. Whether there was any evidence to warrant a jury in finding that certain bad debt losses sustained by the plaintiff in connection with his trade or business of seeking out, promoting, organizing, financing and managing business enterprises?

6. Is a finding that a bad debt was proximately related to that business unwarranted if the taxpayer was not engaged in developing corporations as going businesses for sale to customers in the ordinary course?

Statute Involved

The statutory provisions involved are those of I.R.C. (1954), Section 166, c. 736, 68A Stat. 50, 26 U.S.C. Section 166. A copy of the pertinent provisions is set forth in the appendix hereto.

Statement of the Case

The action was one brought under 28 U.S.C. Section 1346 (a)(1) to recover income taxes paid for the years 1955-1959.

The complaint alleged that the plaintiffs were husband and wife and filed joint income-tax returns for the years involved; that the plaintiff Forrester A. Clark, hereinafter referred to as the taxpayer, was in 1955-1959 and previously engaged in the business of seeking out, promoting, organizing, financing and managing business enterprises; that the plaintiffs in making their returns for those years

claimed deductions for business bad debts; that the Commissioner had disallowed the deductions and assessed deficiencies; that the plaintiffs had paid the deficiencies and filed claims for refund, which the Commissioner had denied (R. 4-10).

The answer admitted the jurisdictional allegations, but denied that the taxpayer was in the business of seeking out, promoting, organizing, financing and managing business ventures, and that the bad debts were incurred in that business. (R. 11-17). These denials raised the only substantial issues in the case.

Both parties claimed a trial by jury. The case was tried before the Honorable Charles E. Wyzanski, Jr., District Judge, and a jury on April 13, 14, 15 and 16, 1965. At the conclusion of the evidence the appellant presented a "motion for a directed verdict on bad debt issue", which the Court denied (R. 1, 114).

The case was submitted to the jury on four special interrogatories, all of which the jury answered in the affirmative. The interrogatories here relevant, were (R. 2):

> "2. Was Mr. Clark engaged in the trade or business of seeking out, promoting, organizing, financing and managing business enterprises during the years 1956, 1957, 1958 and 1959?
>
> 3. Was the bad-debt loss sustained in connection with the Endur Paint Corporation sustained in connection with Mr. Clark's trade or business of seeking out, promoting, organizing, financing and managing business enterprises?
>
> 4. Was the bad-debt loss sustained in connection with Electronic Detection Products, Inc. sustained in connection with Mr. Clark's trade or business of seeking out, promoting, organizing, financing and managing business enterprises?"

The jury's answer to the second interrogatory was not challenged by either the government or the Court of Appeals. (R. 124-125)

The taxpayer testified that he had sought out, promoted, organized, financed and managed approximately forty-five small business companies. (R. 41) He stated that was his business. (R. 18)

Taxpayer pointed out in his testimony that he had a reputation of being interested in small companies and in helping persons finance and run the companies. As a result of his reputation, individuals visited taxpayer for assistance. He in turn obtained the story of the company, a balance sheet and an estimate of what the company's needs are. If he thought the business was worthwhile, he became involved in all aspects of the business, including promoting, organizing, financing and managing it. Taxpayer has investigated the potentialities of over two hundred business enterprises. (R. 41-42)

For his services in organizing, promoting, financing and managing business enterprises, taxpayer received as a reward fees and commissions of cash, stock and stock options. (R. 42, 46, 47, 53) In a number he realized his reward in their sale or liquidation. (R. 43, 45, 48, 61-62, 64)

Among the several hundred business enterprises investigated by taxpayer were two companies known as Endure Paint Company and Electronic Detection Products.

Taxpayer testified that his making or guaranteeing loans, was something he did as part of his business. (R. 23)

Endure Paint Company was a small business in severe financial troubles. (R. 23-28) The principal stockholder of Endure, Baird Eaton, requested assistance from plaintiff. (R. 19-20) He agreed to assist him. He undertook to organize, promote and finance a new corporation called Endure Paint Corporation. (R. 30) Taxpayer obtained financing by personally guaranteeing loans from the Mer-

chant's Warren National Bank of Salem. The loans were made to Eaton individually, and used by him to pay creditors and provide working capital for Endure Paint Corporation. (R. 19, 29-30).

All the stock of Endure Paint Corporation was placed in escrow by Endure Paint Corporation with the Merchant's Warren National Bank of Salem, to secure the loans but the taxpayer had a verbal understanding with Eaton that on the release of the stock from escrow, taxpayer would receive one-third of it. (R. 30-31, 78-80) This stock would come from Eaton individually and not from the corporation. (R. 25, 30, 78) In addition, as a reward for his services, taxpayer received stock from Eaton in a real estate development which Eaton had. (R. 27)

Before Endure Paint Corporation could prosper, however, Baird Eaton became seriously ill and could not operate the business. (R. 20-21, 31) Taxpayer never acquired Eaton's stock because it was not released from escrow by the bank. (R. 80) Taxpayer remained liable to the bank on the notes guaranteed by him. During the years 1956 through 1958 he paid $20,651.58 to the bank, which he sought to deduct as a business bad debt. (R. 18-19, 31)

Although the Court wrote that it had "searched the record" for evidence in the light most favorable to taxpayer, (R. 124) it failed to note that the bad debt sustained in connection with Endure Paint Corporation was one owed by Baird Eaton, the president and principal stockholder of that Company and not by the Company (R. 19-21, 24, 25): that the advances which the taxpayer made were to Baird Eaton, and not to his company, although Mr. Eaton borrowed in order to finance his company; that the compensation which the taxpayer was to receive for his services and his financial aid was to be a part of Mr. Eaton's stock in the Company and was to come not from the Company but from Mr. Eaton; and that he also received from Mr.

Eaton stock in another real estate development called "Highwood Homes". (R. 27).

A promise to transfer shares of stock made by the principal stockholder of a corporation in consideration of loans to the stockholder for the purpose of financing the corporation is hardly the normal reward of an investor in the corporation.

Electronic Detection Products was a small Massachusetts company that had developed an electronic burglar detection device. It badly needed capital. (R. 22)

Because of taxpayer's reputation as a person in the business of organizing, promoting, financing and managing small business enterprises, a bank official asked taxpayer whether he would be interested in assisting Electronic Detection Products. (R. 22)

After his usual investigation, taxpayer decided to promote and finance the company by raising from his friends $100,000. (R. 33) As compensation for his services, he received stock options in the company; at the time the options had no value. (R. 34, 81-82)

Some months later taxpayer discovered that misrepresentations had been made as to the affairs of the company. He testified: "My friend and I had a choice then of suing two people that we didn't think had any money, or else getting rid of it and trying to make it work out. We chose the latter. We had a new president of the company. And we went on the Executive Committee. We had meetings once a week, and really got into it" (R. 35). He secured additional financing from Dealers Acceptance Corporation, a company in which he and another owned all the stock, and gave that company guarantees of the loan it was making to Electronic Detection Products (R. 35). He was later called upon to pay under the guarantees. It is not contended by the United States that the payments did not give rise to bad debts.

The Court of Appeals rejected the jury's findings that the bad debt loss sustained in connection with Electronic Detection Products, Inc. resulted from the taxpayer's business on the theory that the loss was "not proximately related to any promotion." (R. 125)

There was ample evidence to justify the jury's finding that the taxpayer was engaged in the trade or business of seeking out, promoting, organizing, financing and managing business enterprises.

For an individual engaged in such a business it could be found by a jury to be an appropriate business decision not to abandon an enterprise in which he had interested his friends, but to continue efforts to make it prosper. If so, the guarantees of the loans of Electronic Detection Products might be found to be proximately related to his business. The taxpayer was asked (R. 82-83): "Did you receive any reward or compensation for giving this guarantee? A. Not particularly. No. But I did have options on some of the stock of the company. When I get into a company I don't want to see anybody hurt. I want to see it successful. Sometimes it takes more money than I think, to make it successful. Sometimes it doesn't become successful; even if I put in a lot of money. I did it with the idea here, where I had an option on some stock, and my friends were in it with me, and I never let a company go if I can possibly help it. I try to make it successful."

Reasons for Granting the Writ

1. The Decision of the Court of Appeals in This Case Is in Conflict with the Decision of This Court in *Whipple* v. *Commissioner*, 373 U. S. 193.

The Court of Appeals has misconstrued the decision of this Court in *Whipple* v. *Commissioner*, 373 U.S. 193.

The decision in *Whipple* v. *Commissioner*, was that the question whether a worthless debt was proximately related to the taxpayer's business was one of fact. The Tax Court in that case had found as a fact that the taxpayer was not in the business of promoting corporations for a fee or commission or for development and resale. The Court remanded the case to the Tax Court to determine whether the debt was incurred in the petitioner's business of being a landlord.

The decision of the Court of Appeals in this case was that the worthless debts could not be found to be proximately related to the taxpayer's business, unless he could show that he had an intention of developing the corporations involved as going businesses for sale to customers in the ordinary course. The opinion states (R. 124):

> "In order to sustain a finding that the taxpayer is engaged in the trade or business of promoting or financing corporations, he must show that his reward or compensation from these corporations is different from that flowing to an investor and that he had an intention of 'developing the corporations as going businesses for sale to customers in the ordinary course'. *Whipple* v. *Commissioner* supra; *Bodzy* v. *Commissioner*, 321 F.2nd 331 (5th Cir. 1963). Without this additional evidence, the furnishing of organizational, promotional and managerial services to corporations is not a trade or business within the meaning of the statute."

Whipple does not support the statement for which it is cited. This Court there said:

> "To be sure, the presence of more than one corporation might lend support to a finding that the tax-

payer was engaged in a regular course of promoting corporations for a fee or commission, see Ballantine, Corporations (rev. ed. 1946), 102, or for a profit on their sale, see *Giblin* v. *Commissioner*, 227 F.2nd 692 (C. A. 5th Cir.), but in such cases, there is compensation other than the normal investor's return, income received directly for his own services rather than indirectly through the corporate enterprise, and the principles of Burnet, DuPont and Higgins are therefore not offended."

The taxpayer could not have developed the corporations for sale to customers in the ordinary course because he did not own a controlling interest in the companies. But as *Whipple* points out, this is not the controlling test. There must be a showing that taxpayer is engaged in an independent trade or business apart from the furnishing of "regular services to one or many corporations." 373 U. S. at 202. The jury in this case found as a fact that taxpayer had such an independent trade or business. And there must be a further showing that the compensation received was other than the "normal investor's return." The jury also found that taxpayer's compensation was other than a normal investor's return.

In this case the taxpayer's services were to be rewarded by a fee or commission, payable in stock in the case of Endure Paint Corporation, and in stock options in the case of Electronic Detection Products. The reward was to be furnished not by the corporations, as the opinion of the Court of Appeals erroneously assumes (R. 121), but by Baird Eaton, the principal stockholder of Endure Paint Corporation, and by all the existing stockholders of Electronic Detection Products Company. Stock options when exercised result in a payment to the corporation,

not by it, though they dilute the interest of the other stockholders. See Ballantine, *Corporations*, § 220.

The receipt of such considerations for promoting, financing, and managing business enterprises is not the normal investor's return.

The only issue which this Court resolved as a matter of law in *Whipple* was that the furnishing of regular services to one or many corporations does not of itself constitute an independent trade or business to enable a taxpayer to deduct as business bad debt losses incurred by reason of advances to such a corporation. But the Court of Appeals misconstrued *Whipple* and in so doing deprived the plaintiffs of their right to jury trial under the Seventh Amendment to the Constitution. Questions whether taxpayer had an independent trade or business of organizing, promoting and financing corporations and whether bad debt losses were proximately related to that business are factual issues for determination by a jury. *Whipple* did not suggest otherwise.

The Court of Appeals, however, has substituted its judgment for the very factual issues resolved favorably to taxpayer by the jury. The Court states that taxpayer's status in Endure "did not rise above the level of an investor" and his subjecting of his assets to the risks of the business of Electronic Detection Products "constituted merely an investment by the taxpayer." (R. 125) The jury found, however, as a fact that taxpayer was not an investor and that his advances were part of his trade or business.

2. THE COURT OF APPEALS DECISION CONFLICTS WITH THE DECISION OF THIS COURT IN *Whipple* v. *Commissioner*, 373 U.S. 193 AND THE DECISION OF THE COURT OF APPEALS FOR THE SECOND CIRCUIT IN *Weddle* v. *Commissioner*, 325 F.2d 849 ON THE ISSUE OF THE PROXIMATE RELATIONSHIP OF THE BAD DEBT TO THE TAXPAYER'S BUSINESS.

The question which this Court left open in *Whipple* is: when is a debt proximately related to the taxpayer's business. This is an important issue, and one which constantly recurs in tax practice. In *Whipple*, the Court remanded the case to the Tax Court to determine as a matter of fact whether the debt was proximately related to the taxpayer's real estate business, but it laid down no guide lines for the courts below.

In *Weddle* v. *Commissioner*, 325 Fed. (2nd) 849, 851 (C.A.-2), Judge Friendly, speaking for a majority of the Court, wrote: "So here, particularly in view of the backhanded wording of § 166, it suffices for the deduction that the creation of the debt should have been significantly motivated by the taxpayer's trade or business, even though there was a non-qualifying motivation as well."

In *Decker* v. *United States*, 244 F.S. 31, 37, (D.C. N.D. Iowa), the Court approved the test laid down in the *Weddle* case, although it held the debt involved a business debt no matter what the test.

The test of significant motivation was also applied in *Louise Lesser*, 42 T.C. 688, citing in addition to *Whipple* and *Weddle*, *Wilfred J. Funk*, 35 T.C. 42, 49, acq. 1961-2 C.B.4, *Eugene H. Rietsdike*, 40 T.C. 443, 450-451, and *J. T. Dominey*, 26 T.C. 940, 945.

In *Wilfred J. Funk,* supra, the Court wrote:

> "We may readily agree with the Government that one of the purposes of establishing and operating Wilfred Funk, Inc., was to create and utilize a vehicle for engaging in the publishing business, a business that cannot be attributed to petitioner in view of the corporate entity . . . But on the evidence, we also agree with petitioner that another, and important purpose was to provide him with a ready publishing outlet for his own works, and to enhance and exploit his reputation as a writer. The mere fact that the corporation published the works of a number of other authors does not at all detract from the substantial part that it was intended to play and in fact did play in the promotion of petitioner as a writer. Moreover, the use of his own name in the corporate title, even when publishing the words of other authors, was a means of keeping his name before the public to assist in the acceptance and sale of his own books, and had Wilfred Funk, Inc. failed financially, petitioner felt it would be a serious blow to his professionel reputation and prestige."

In an article by Lipman Redman, entitled "Bad Debts," appearing in 22nd *Annual New York University Institute on Federal Taxation,* pp. 315-352, the writer said of the *Whipple* case, on p. 325:

> "In effect the Court refrained from promulgating any rules or guidelines as to the qualification for business bad debt treatment of 'the business of money lending, of financing corporations, of bottling soft drinks or of any combination of these'. Nor did the

Court rule out the possibility of such preferred treatment when the loan was made by a salaried corporate executive to keep his job or otherwise in direct relationship to his alleged separate trade or business as a corporate employee. Conceivably those areas remain for other taxpayers to pursue. In fact the Court did remand for findings as to the relationship between the loan—bad debt and taxpayer's business as landlord."

In another article by Daniel C. Knickerbocker, Jr., entitled *"What Constitutes a Trade or Business for Bad Debt Purposes"*, appearing in 23rd *Annual New York University Institute on Federal Taxation,* pp. 113-133, the writer said:

"Mr. Whipple did not have his second trial. A settlement was reached when the case came on in the Tax Court for hearing on the remand. The outcome, which the taxpayer's lawyers say was favorable, was strongly influenced by the entirely new concept of proximate cause which Judge Friendly outlined in *Weddle.* Under that concept, whether a debt has a business nexus or not will no longer be decided by looking only at those taxpayer motives that stick out like sore thumbs. The courts will be required rather to consider all of the ends being served, to determine which of these were 'significant' and to measure the significant motives against the standards for deductibility. It is just faintly possible that in this tortuous process we will find the way to escape the *Whipple* dilemma."

The Court of Appeals for the First Circuit did not follow the significant motivation test of *Weddle* v. *Com-*

missioner, supra. The Court of Appeals erroneously assumed that *Whipple* was similar to this case and concluded that taxpayer's receipt of stock and stock options constituted the normal investor's return. (R. 124-125)

The obvious fallacy in the Court of Appeals' decision is that *Whipple* is completely distinguishable from this case. In *Whipple* there was a finding by the Tax Court that taxpayer was not engaged in the business of organizing, promoting and financing corporations. Here the jury found that taxpayer was in such an independent business.

When this basic distinction was brought to the attention of the Court of Appeals on a petition for a rehearing, the Court conceded that it did not believe *Whipple* was "on all fours" with this case, but thought *Whipple* controlling because of "its clear implication that when a taxpayer's loss-producing activities are at least equally consistent with his being an investor or with his being in the business of promoting, financing or managing the enterprise in question, he has not met his burden." (R. 134-136)

But there is no such implication in *Whipple.* This Court did not say that a jury could not resolve the basic factual issue in these cases: whether the debt arose from an investment or from promotional activities.

This was recognized by the Second Circuit in *Weddle* v. *Commissioner,* supra. It ruled that even if a taxpayer had non-qualifying motivations in making a loan, if there was also a significant business motive, an ensuing loss would make the debt deductible. That standard obviously was not followed by the First Circuit in this case.

To the contrary, the First Circuit wrongly required evidence that the taxpayer's motivation was that he intended to develop the companies "for sale to prospective investors." (R. 125)

The jury in this case could properly find on all the evidence that taxpayer was in an independent trade or business of seeking out, organizing, promoting, financing and managing a variety of business enterprises, that as an integral part of that business, he made or guaranteed loans to two companies, that his significant, if not exclusive, motivation in making or guaranteeing the loans was the relationship of the loans to his independent business, and that the subsequent losses incurred by taxpayer were deductible as business bad debt losses.

Conclusion

For the reasons set forth above, it is respectfully submitted that the petition for a writ of certiorari should be granted.

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Appendix A

United States Court of Appeals
For the First Circuit

No. 6617.

UNITED STATES OF AMERICA,

DEFENDANT, APPELLANT,

v.

FORRESTER A. CLARK ET AL.,

PLAINTIFFS, APPELLEES.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS

Before ALDRICH, *Chief Judge*,
McENTEE and COFFIN, *Circuit Judges*.

Solomon L. Warhaftig, Attorney, Department of Justice, with whom *Richard M. Roberts*, Acting Assistant Attorney General, *Lee A. Jackson* and *David O. Walter*, Attorneys, Department of Justice, *W. Arthur Garrity, Jr.*, United States Attorney, and *John Paul Sullivan*, Assistant U. S. Attorney, were on brief, for appellant.

Philip M. Cronin, with whom *Edward C. Park* was on brief, for appellees.

OPINION OF THE COURT.

March 14, 1966.

McENTEE, *Circuit Judge*. Plaintiff taxpayer [1] is a senior partner in a well known securities brokerage firm in Boston from which he derives the major part of his income. He claims that also he is individually in the separate business of seeking out, promoting, organizing, financing and managing business ventures and has "quite a number of small

[1] His wife was joined as a party plaintiff only because joint returns were filed.

businesses."[2] Apparently taxpayer had acquired a reputation for helping small companies. Amongst the business ventures in which the taxpayer became actively interested during the recent past, were two small Massachusetts corporations known as Endure Paint Corporation and Electronic Detection Products Company, both of which eventually became insolvent. Neither of these corporations had any connection with the other. At various times between 1955 and 1959, the taxpayer personally guaranteed the obligations of these two corporations and made a direct loan to one of them.

Basically, this appeal presents the question whether the taxpayer is entitled to deduct as business bad debts, losses sustained by him resulting from these guarantees and this loan. This in turn presents the narrower question of whether these were *business* bad debts within the meaning of Section 166 of the Internal Revenue Code of 1954.[3]

Briefly the facts are these. In 1952 one Eaton, a friend of the taxpayer and also the president and principal stockholder of Endure Paint Company, which was then a failing business, sought the taxpayer's financial assistance and advice. In the two years that followed the taxpayer advised Eaton with reference to the management of the busi-

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[2] Taxpayer testified that over the years he had become actively involved in some forty-five business enterprises.

[3] "SEC. 166. BAD DEBTS.

(a) *General Rule.*—

(1) *Wholly worthless debts.* — There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

* * * *

(d) *Nonbusiness Debts.*—

(1) *General Rule.* — In the case of a taxpayer other than a corporation—

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting there-

ness and obtained several loans for Endure by endorsing its notes to the bank. When these notes became due and Endure was unable to pay them he either paid the notes himself or loaned Endure the money to pay them. Taxpayer received no interest on these loans. For these efforts the taxpayer from time to time received stock in the company. When received, this stock had no value.

In 1955 Endure again fell into bad times and the taxpayer arranged a settlement with its creditors. A new corporation, Endure Paint Corporation, was formed to take over the business of the old company. The taxpayer financed this new corporation by obtaining two bank loans totalling $25,000 and personally executed the notes. Part of these funds were to be used for working capital for the new corporation. The stock of the new corporation was placed in escrow as security for creditors. It was agreed that when this stock was released the taxpayer would received about one-third of it. Taxpayer testified this was a reward for his services. At that time the stock had no value but the taxpayer hoped to make it valuable by making the company successful.

In 1956 taxpayer loaned Endure an additional $3,000, making a total of $18,651.58 loaned to or guaranteed by the taxpayer. In October of 1956 Eaton notified the taxpayer

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from shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) [as amended by Sec. 8, Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606] *Nonbusiness debt defined.* — For purposes of paragraph (1), the term 'nonbusiness debt' means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

* * * "

that because of a serious illness he could not continue in business. The company was liquidated and as a result the taxpayer incurred the following losses on his loans and guarantees: $7,000 in 1956; $8,000 in 1957 and $5,651.58 in 1958.

Taxpayer became interested in Electronic Detection in 1957 when its officers approached him with the view to obtaining additional capital. He succeeded in raising $100,000 for this company from several friends. For this the taxpayer received an option to purchase stock in the company. When received, this option had no value but the taxpayer hoped the company would become successful and the stock would thereby become valuable. He was chosen a director of this company and later went on its executive committee. For his management services he received additional stock options from the company.

In the fall of 1957 taxpayer guaranteed a substantial loan for the company. Thereafter the company went into the red and in December of 1958 the taxpayer was obliged to pay $30,000 on his guarantee. However, at the same time he signed a second guarantee for approximately $27,000 because he said he wanted to see the company "keep going." At that time he owned about a 30% interest in it. In February of 1959 demand was made on Electronics Detection for repayment of this loan and, the company being insolvent, taxpayer was required to pay $23,000 pursuant to his second guarantee. He received no compensation for making these guarantees.

None of said payments made to or on behalf of either Endure or Electronics Detection were ever recovered by the taxpayer, and he deducted these losses in full as business bad debts on his federal income tax returns. The Commissioner disallowed these deductions. Deficiency assessments followed which were paid. After denial of claims

for refund the taxpayer brought this suit. Both sides claimed a jury trial and the case was submitted to the jury on four special questions.[4]

At the close of the evidence the government moved for a directed verdict on the ground that the taxpayer's activities, as a matter of law, did not constitute a *business* within the meaning of the bad debt statute. The trial court denied this motion. The jury answered "Yes" to all four questions and returned a verdict for the taxpayer. Thereupon and for the same reasons given in support of its motion for direction of a verdict, the government moved for judgment notwithstanding the verdict which motion was also denied. On appeal, the government contends that the trial court erred in denying its motions.

It is well settled that the burden was on the taxpayer to show that he was entitled to the claimed deductions. *White* v. *United States,* 305 U.S. 281 (1938); *United States* v. *Byck,* 325 F.2d 551 (5th Cir. 1963). In order to prevail here he had to show (1) that he was individually in the *business* of seeking out, promoting, organizing, financing and managing business ventures as claimed; (2) that his activities with regard to Endure and Electronic Detection were a part of that business; and (3) that his said guaran-

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[4] Only questions 2, 3 and 4 are material on this appeal. They are as follows:

> "2. Was Mr. Clark engaged in the trade or business of seeking out, promoting, organizing, financing and managing business enterprises during the years 1956, 1957, 1958 and 1959?
>
> "3. Was the bad-debt loss sustained in connection with the Endure Paint Corporation sustained in connection with Mr. Clark's trade or business of seeking out, promoting, organizing, financing and managing business enterprises?
>
> "4. Was the bad-debt loss sustained in connection with Electronic Detection Products, Inc., sustained in connection with Mr. Clark's trade or business of seeking out, promoting, organizing, financing and managing business enterprises?"

tees and loan and the losses resulting therefrom were proximately related to said individual business. *United States* v. *Byck, supra.*

The leading authority on the basic question involved here is *Whipple* v. *Commissioner,* 373 U.S. 193 (1963), in which the Supreme Court laid down the tests as to what constitutes a business within the meaning of Section 166. In that case the court said at p. 202: "Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged." In order to sustain a finding that the taxpayer is engaged in the trade or business of promoting or financing corporations, he must show that his reward or compensation from these corporations is different from that flowing to an investor and that he had an intention of "developing the corporations as going businesses for sale to customers in the ordinary course." *Whipple* v. *Commissioner, supra; Bodzy* v. *Commissioner,* 321 F.2d 331 (5th Cir. 1963). Without this additional evidence, the furnishing of organizational, promotional and managerial services to corporations is not a trade or business within the meaning of the statute.

The legal principles announced in *Whipple* are controlling here. We have searched the record and viewing the evidence in the light most favorable to the taxpayer, we do not find this necessary "additional evidence" as required by *Whipple.* While there is some evidence that the taxpayer may have been engaged in the business of promoting corporations,[5] even if promoting corporations may include rehabilitating old ones there is no evidentiary basis for holding that his activities with regard to Endure and Electronic Detection were part of that business, i.e., that he

[5] The government concedes that over the years the taxpayer can be said to have "promoted" six business enterprises.

was promoting these two companies. Nor is there any evidence that the taxpayer intended to develop these corporations "as going businesses for sale to customers in the ordinary course" or that the compensation[6] received by him from either corporation was different from that flowing to an investor. Taxpayer's sole activity in rendering advice and making advances to Endure in and of itself did not amount to a promotion. There is no evidence whatever that taxpayer intended to develop this company for sale to prospective investors. Clearly his status in this company did not rise above the level of an investor.[7]

Assuming that taxpayer's raising of $100,000 on behalf of Electronic Detection was a "promotion", the subsequent guarantees of two substantial loans to cover the operating deficits of this failing company were not proximately related to any promotion. Taxpayer was seeking to make the corporation successful in order that the value of his stock options would be enhanced and that the investments of his friends would be protected. According to his own testimony, taxpayer received no compensation for these guarantees. This subjecting of his assets to the risks of the corporation business constituted merely an investment by taxpayer. See *Pokress* v. *Commissioner,* 234 F.2d 146, 150 (5th Cir. 1956).

In view of the explicit language of *Whipple* and its similarity to the instant case, we must conclude that the trial court erred in denying the government's motions for a directed verdict and for judgment notwithstanding the verdict on the *business* bad debt issue. However, any verdict or judgment for the government in this case should be limited to this issue since it is clear the taxpayer would

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[6] All he received from Endure was worthless stock and all he received from Electronic Detection were options to purchase stock that at best had only a speculative value.

[7] *United States* v. *Byck, supra.*

be entitled to recover some amount as *nonbusiness* bad debt deductions.

The judgment of the district court is vacated, the verdict is set aside, and the case is remanded to that court for further proceedings consistent herewith.

Appendix B

United States Court of Appeals
For the First Circuit

No. 6617.

UNITED STATES OF AMERICA,
DEFENDANT, APPELLANT,
v.
FORRESTER A. CLARK ET AL.,
PLAINTIFFS, APPELLEES.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS

Before ALDRICH, *Chief Judge*,
MCENTEE and COFFIN, *Circuit Judges*.

Solomon L. Warshaftig, Attorney, Department of Justice, with whom *Richard M. Roberts*, Acting Assistant Attorney General, *Lee A. Jackson* and *David O. Walter*, Attorneys, Department of Justice, *W. Arthur Garrity, Jr.*, United States Attorney, and *John Paul Sullivan*, Assistant U. S. Attorney, were on brief, for appellant.

Philip M. Cronin, with whom *Edward C. Park* was on brief, for appellees.

OPINION OF THE COURT
ON PETITION FOR REHEARING.
April 27, 1966.

PER CURIAM. In his petition for rehearing, taxpayer asserts that the facts of *Whipple* v. *Commissioner*, 1963, 373 U.S. 193, make that case clearly distinguishable from the case at bar. If our opinion gave the impression that we thought the facts were on all fours, we do not so believe. We thought *Whipple* to be controlling because of its clear implication that when a taxpayer's loss-producing activities

are at least equally consistent with his being an investor as with his being in the business of promoting, financing or managing the enterprises in question, he has not met his burden. In the case at bar taxpayer's other activities, introduced as background evidence, are not relevant, for they cut neither one way nor the other so far as the particular losses in issue are concerned. We can find no substantial affirmative evidence that these were suffered other than as an investor within the *Whipple* definition.

Petition denied.

Appendix C

INTERNAL REVENUE CODE (1954)

Section 166. Bad Debts.

(a) General Rule.

(1) Wholly worthless debts. There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

* * *

(b) Amount of Deduction. For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

* * *

(d) Nonbusiness debts.

(1) General Rule. In the case of a taxpayer other than a corporation—

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) Where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) Nonbusiness debt defined. For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than

(A) A debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 1321

FORRESTER A. CLARK, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

This case concerns the proper income tax treatment of bad debt losses incurred by petitioner in connection with the financing of two corporations. The court of appeals rejected petitioner's contention that he was entitled to business bad debt deductions with respect to these losses and held that the district court had erred in denying the government's motions for a directed verdict and for judgment notwithstanding the verdict on the ground that petitioner was entitled

only to nonbusiness bad debt deductions. This decision is in accord with the decided cases, and there is no reason for further review.

This Court has held that a taxpayer seeking a business bad debt deduction must demonstrate that the loss in question arose from activities producing a return to him other than that of an investor, rather than from activities peculiar to an investor concerned with, and participating in, the conduct of the corporate business. *Whipple* v. *Commissioner*, 373 U.S. 193, 202. See also *Bodzy* v. *Commissioner*, 321 F. 2d 331 (C.A. 5); *United States* v. *Byck*, 325 F. 2d 551 (C.A. 5). In the instant case there is no evidence whatever that petitioner's activities from which the bad debt losses resulted were other than those of an investor. It is undisputed (Pet. 10) that petitioner was not developing these corporations for sale to customers in the ordinary course. Like any other investor petitioner's only possible return was enhancement in the value of, and the receipt of dividends with respect to, his stock.[1] Since the evidence showed that the losses in question were no more than losses by an investor, resulting from transactions entered into by him to bring profit to the corporations, and thereby to their shareholders, the district court erred in denying the government's motions for a

[1] According to petitioner's own testimony (R. 80), the Endure Paint Corporation stock that he was to receive had no value. Similarly, petitioner's only possible return from Electronic Detection Products Company was as an investor through enhancement in value of stock options that he held in the corporation.

directed verdict, and for judgment notwithstanding the verdict. See *United States* v. *Byck, supra.* The decision below is wholly in keeping with, and is required by, *Whipple* v. *Commissioner, supra,* where this Court held (p. 203) that since:

> there was no intention here of developing the corporations as going businesses for sale to customers in the ordinary course, the case before us inexorably rests upon the claim that one who actively engages in serving his own corporations for the purpose of creating future income through those enterprises is in a trade or business. That argument is untenable * * *, and we reject it. Absent substantial additional evidence, furnishing management and other services to corporations for a reward not different from that flowing to an investor in those corporations is not a trade or business under [the predecessor to the provision here in question].

There is no conflict between the decision below and that of the Second Circuit in *Weddle* v. *Commissioner,* 325 F. 2d 849. In that case the question was whether the taxpayer's bad debt loss arose from her trade or business of serving as the president and general manager of the corporation or from her activities as controlling shareholder of the corporation. The Tax Court held that the taxpayer had failed to sustain her burden of showing that protection of her trade or business of employment with the corporation had been a significant motivation for her guarantees of the corporation's obligations, *i.e.*, it ruled that in making the guarantees the taxpayer had acted as an investor. On appeal the Second Circuit affirmed. In the instant

case there is no evidence whatsoever that petitioner's relation to the corporations was anything but that of an investor when he made the advances and guaranteed the loans that resulted in the losses that are in issue. *Weedle* thus supports rather than conflicts with the decision in the present case.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

THURGOOD MARSHALL,
Solicitor General.

MITCHELL ROGOVIN,
Assistant Attorney General.

DAVID O. WALTER,
SOLOMON L. WARHAFTIG,
Attorneys.

JUNE, 1966.

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